Internal Revenue Service

memorandum

CC:FS-TL-N-10466-91
CORP:JMSchwartzman

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to: District Counsel, Sacramento CC:SAC
Attn: Steven J. Mopsick

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted]

This memorandum responds to your September 11, 1991 request for advice concerning the leveraged buyout of [redacted]. Specifically, you request whether the Service can disallow taxpayer's I.R.C. § 338 election based on the facts and the applicable law. As discussed in more detail below, we believe that the Service should pursue development of several arguments which might be used to challenge the validity of taxpayer's section 338 election. We emphasize that our recommendation is tentative at this point since the facts have not been fully developed. As the facts are developed, we will work with your office to develop the appropriate legal arguments based on those facts, in continued coordination with CC:CORP. The individuals in CC:CORP who are involved are Donald Osteen (566-3224), Virginia Voorhees (566-4581), and Keith Medleau (566-3555).

As you request in your memorandum, we attach a list of questions which we hope will assist you in developing the facts relating to the arguments discussed below.

We greatly appreciate your early communication with us in connection with this matter. We believe that the Service is best served by the National Office and the Field acting in concert to properly and effectively prepare cases for litigation or other appropriate disposition, as soon as significant cases are identified.

ISSUE

Whether the Service can disallow taxpayer's section 338 election to step up the basis of assets of [redacted] where certain members of a [redacted] percent controlling family group took the company private in a leveraged buyout.

FACTS

As of [redacted], [redacted] ([redacted]) had approximately [redacted] shares of one class of common stock outstanding. Descendants of the company's founder, [redacted], owned approximately [redacted] percent of those shares (family member shareholders), while the rest were publicly held.[1]

On [redacted], [redacted] family member shareholders formed a new corporation, [redacted] ([redacted]). [redacted] borrowed $[redacted] to buy out the publicly held shares and some of the family member shares. To facilitate this plan, [redacted] entered into agreements with the family member shareholders. There were two types of agreements, noninvestor and investor. Family member shareholders who signed the noninvestor agreements agreed to sell their shares to [redacted] or to sell or otherwise dispose of their shares "in such a manner to which [[redacted]] has consented in writing." Family member shareholders who signed the investor agreements agreed to sell or otherwise dispose of their

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1 We use the term "family member shareholders" in this memorandum to designate an identifiable group which played a significant role in this transaction. We do not, however, draw any legal conclusions by use of this term. Legal conclusions concerning the section 318(a) attribution rules requires further factual development.

shares to [redacted] or to sell their shares "in such a manner to which [[redacted]] has consented in writing." In addition, to the extent that the investor family member shareholders did not sell their shares to [redacted], they agreed to exchange their [redacted] shares for stock in [redacted].

On [redacted] made a tender offer for all the outstanding stock of [redacted] at $[redacted] per share. On [redacted], some of the family member shareholders sold [redacted] percent of the outstanding shares to [redacted] and [redacted] of its customers for $[redacted] per share. [redacted] then sold these shares to [redacted] at $[redacted] per share by [redacted], the expiration date of the tender offer. By [redacted], those family member shareholders who had not sold all of their stock to [redacted] (or to [redacted]) exchanged their remaining [redacted] stock for shares in [redacted]. Approximately [redacted] percent of [redacted] outstanding shares were exchanged for stock of [redacted]. After the leveraged buyout, the family member shareholders owned at least [redacted] percent of the [redacted] stock. One of the family member shareholders, [redacted] ([redacted]), directly owned [redacted] percent of the [redacted] stock.

After the transaction was completed, [redacted] owned [redacted] percent of the outstanding stock of [redacted]. [redacted] then made an election under section 338 to step up the basis in the assets of [redacted].

ANALYSIS

I. Introduction

Section 338, as it was in effect for the taxable year at issue, provided that if a purchasing corporation made an election under that section, the target corporation shall be treated as having sold all its assets for their fair market value to a new corporation in a transaction to which section 337 applies. Section 338(a). This provision applied in the case of any "qualified stock purchase." Section 338(a).

A qualified stock purchase means any transaction or series of transactions in which one corporation acquires another corporation by purchasing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of all other classes of stock (except nonvoting preferred). Section 338(d)(3). The term purchase for purposes of section 338 means any acquisition of stock, but only if:

> (i) the basis of the stock in the hands of the purchasing corporation is not determined in whole or in part by reference to the basis of the stock in the hands of the person from whom the stock was acquired;
>
> (ii) the stock is not acquired in an exchange to which section 351, 354, 355 or 356 applies and is not acquired in any other transaction described in the regulations in which the transferor does not recognize the entire amount of gain or loss on the transaction; and
>
> (iii) the stock is not acquired from a person the ownership of whose stock would be attributed to the person acquiring such stock under the attribution rules of section 318(a). Section 338(h)(3)(A)(i), (ii) and (iii).

I.

A. <u>The Theories</u>

We believe that the Service should pursue development of two theories that could support the disallowance of taxpayer's section 338 election. We describe them both here briefly and then explain them in more detail below. Both theories are based on the argument that [redacted] was acting as a mere conduit and, therefore, the sales to [redacted] and from [redacted] to [redacted] should be ignored for tax purposes.

The first theory develops the conduit argument to indicate that the stock purchased by [redacted] through [redacted] was acquired from related parties within the meaning of section 318(a) and, therefore, [redacted] did not "purchase" the requisite 80 percent of [redacted] stock to qualify for a section 338 election. Section 338(h)(3)(A)(iii). We emphasize that we do not currently have sufficient facts to determine whether this theory is supportable. In this regard, we depend upon your efforts to develop the facts of this transaction and, as noted above, we will work with your office to develop the appropriate legal theories in conjunction with your factual developments.

The second theory recasts the "purchase" as a section 351 transaction. As the facts developed to this point indicate, the family member shareholders owned at least [redacted] percent of the [redacted] stock after the transaction. As a result, they controlled [redacted] for purposes of section 351. According to this theory, any cash received by the family member shareholders who receive both stock and cash (but not shareholders who receive only cash) in that transaction would constitute boot. Section 338(h)(3)(A)(i) or (ii).

We are also considering a third theory that may support disallowance of taxpayer's section 338 election. This theory recharacterizes the "purchase" as a redemption by [redacted] of the shares that were acquired from the shareholders for cash. To succeed in advancing this theory, we must affirmatively show that [redacted] was the real borrower of the $[redacted] and that [redacted] was merely a conduit or agent in getting those funds to shareholders of [redacted] in exchange for their [redacted] shares. According to this theory, the [redacted] shares that were not acquired for cash were acquired in exchange for [redacted] stock in a transaction which qualified as a "B" reorganization or section 351 transaction.[2] Thus, because the basis of the stock in the hands of [redacted] is determined by reference to the basis of the stock in the hands of the transferors and because the stock was acquired in a transaction to which section 354 applies, the [redacted] stock was not purchased within the meaning of section 338(h)(3). *See* sections 338(h)(3)(A)(i) and (ii). As a result, a section 338 election was not available to the taxpayer. Advancing this theory, however, may affect Service position in areas other than corporate taxation. Accordingly, we are coordinating this theory with other functions before finalizing our commitment relative to advancing it in this case. Nonetheless, we recommend that your office pursue the factual development that would support this theory.

I.

B. The First Theory-Explanation

The starting point for the first theory is that the [redacted] percent block of [redacted] shares which were exchanged for [redacted] stock were not purchased within the meaning of section 338. The exchange of those shares did not constitute a purchase for purposes of section 338 because

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[2] Under this theory, the [redacted] stock acquired in exchange for [redacted] stock (and not for cash) would constitute all of the [redacted] stock acquired by [redacted] for purposes of section 338. Thus, the stock redeemed by [redacted] would not taken into account in determining whether [redacted] acquired "by purchase" the requisite 80 percent control. Since the [redacted] stock was exchanged for [redacted] stock in a transaction qualifying as a "B" reorganization, the purchase requirement of section 338 would not be met.

the [redacted] stock[3] was transferred to [redacted] solely in exchange for stock in [redacted] and, immediately after the transfer, the transferors owned more than 80 percent of the only class of [redacted] stock. Thus, the exchange constituted a section 351 transaction.[4] Section 351(a). *See also* sections 368(c) and 351(b). Exchanges to which section 351 apply are specifically excluded from the section 338 definition of purchase. Section 338(h)(3)(A)(ii). Thus, the [redacted] percent block of shares transferred in the section 351 transaction were not purchased within the meaning of section 338.

We have attempted to show that [redacted] percent of the [redacted] stock was not acquired by purchase. If that is so, the Service can disallow the taxpayer's section 338 election if it can demonstrate that an additional [redacted] shares were also not acquired by purchase.[5]

The next step in this theory is premised on the contention that [redacted] was acting as a mere conduit.[6] That is, [redacted]s transitory ownership of the [redacted] stock must be ignored for federal income tax purposes. This contention can be made through three similar legal theories: transitory ownership, conduit and step-

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[3] Stock of a corporation (other than stock of the transferee corporation) constitutes "property" for purposes of section 351. Rev. Rul. 74-501, 1974-2 C.B. 116; PLR 8134092.

[4] Where the requirements of section 351 are met, nonrecognition is mandatory. *Mertens Law of Federal Income Taxation* § 43A.01.

[5] [redacted] percent of [redacted] (the number of [redacted] shares outstanding before the transaction) equals [redacted] shares. Assuming the [redacted] percent block of shares exchanged for [redacted] stock was not purchased within the meaning of section 338(d)(3), we need to show that an additional [redacted] shares were not acquired by purchase to disallow taxpayer's section 338 election.

[6] We include the shares sold to clients of [redacted] with those sold to [redacted] for simplicity and because, based on the information we have at this time, those sales should be accorded identical treatment for tax purposes.

transaction. We review each of them in turn and then complete our explanation of the first theory.

I.
B. 1. Transitory Ownership

It is well-established that a taxpayer can structure his affairs to incur the least amount of tax on his transactions by all legal means. *Court Holding Co. v. Commissioner*, 324 U.S. 331 (1945). It is equally well established, however, that commercially meaningless formalisms employed to avoid appropriate taxation are ignored for tax purposes. *Court Holding Co., supra*; *Commissioner v. Knetsch*, 364 U.S. 361 (1960); *Higgins v. Smith*, 308 U.S. 473 (1940); *Griffiths v. Commissioner*, 308 U.S. 355 (1940).

The benefits and burdens of property mark the true ownership of property. *Anderson v. Commissioner*, 164 F.2d 870 (7th Cir. 1947), *cert. denied*, 334 U.S. 819 (1948); *Rupe Investment Corporation v. Commissioner*, 266 F.2d 624 (5th Cir. 1959). Accordingly, the courts have long recognized that transitory ownership, as part of a prearranged plan, is of no substance for tax purposes. *Helvering v. Bashford*, 302 U.S. 454 (1937); *Commissioner v. Ashland Oil & Refining Co.*, 99 F.2d 588 (6th Cir. 1938); *Overland Corporation v. Commissioner*, 42 T.C. 26 (1964). That is, transitory owners of property do not bear the benefits and burdens of ownership and are not the beneficial owners of the property for the short period they hold legal title.

In *Overland Corporation, supra*, the Tax Court held that a transfer of assets to a corporation pursuant to a bankruptcy order did not qualify as a nontaxable transaction. The court concluded that the transferors did not have the requisite control of the corporation immediately after the transfer, based on the fact that the transferor's control of the corporation was transitory. The transitory nature of the transferors control was evidenced by the bankruptcy order, which required the transferors to sell their stock in the corporation after the transfer. In addition, the transferors' sale of the corporation's stock was intended by the parties from the outset of the transaction. *Overland Corporation*, 42 T.C. at 69. The court cited language from *Maine Steel, Inc. v. United States*, 174 F. Supp. 702, 713 (D. Maine 1959):

> The transfer of the stock from Products to Fidelity and its sale by Fidelity to the Soule group was contemplated from the inception of the plan of reorganization; it was an integral part of the plan as adopted by the stockholders of Products and formalized by the written agreement signed by Mr. Soule, as President of Products and individually, and by Mr. Braun, as Conservator of Fidelity; and even assuming that there was, as plaintiff asserts, no *legally* binding obligation on Fidelity to sell plaintiff's stock to the Soule group, it is manifest that the incorporation and exchange would never have been agreed upon without the supplemental agreement turning over the stock to Fidelity and eventually to the Soule group, which was, in fact, the *sine qua non* of the entire transaction. ... In situations such as that disclosed by the present record, the courts properly have refused to break up a unified transaction into its constituent elements, and have not hesitated to find that what was done amounted to one single transaction for income tax purposes. *Overland Corporation*, 42 T.C. at 66-67. (emphasis in the original)

Similarly, on our facts, it appears that the sales by the family member shareholders to [redacted] and the sales from [redacted] to [redacted] were contemplated from the inception of the transaction. Recommended factual development is outlined in an attached memorandum.

I.

B. 2. <u>Conduit</u>

A similar argument can be made that [redacted] was acting as a conduit between the family member shareholders and [redacted]. *Cumberland Public Service Co. v. United States*, 338 U.S. 451 (1950); *Commissioner v. Court Holding Company*, 324 U.S. 331 (1945); *Gregory v. Helvering*, 293 U.S. 465 (1935). *See also McWilliams v. Commissioner*, 331 U.S. 694, 700-701 (1947) ("Congress, with such purpose in mind, could not have intended to include within the scope of § 24(b) only simple transactions made directly or through a dummy, or to exclude transfers of securities effected through the medium of the Stock Exchange, unless it wanted to leave a loop-hole almost as large as the one it had set out to close."); *Reef Corporation v. Commissioner*, 368 F.2d 125, 130 (5th Cir. 1966) ("He was a mere conduit in a preconceived and prearranged unified plan to redeem the stock of the Favrot group in Reef Fields."); *West Coast Marketing Corp. v. Commissioner*, 46 T.C. 32 (1966).

In the seminal case of *Gregory v. Helvering, supra*, the taxpayer desired the stock of corporation held as an asset by her wholly-owned corporation, but did not wish to incur the tax liability flowing from having her corporation distribute the stock to her as a dividend. Instead, the taxpayer significantly reduced her tax liability on receipt of the stock by causing her corporation to transfer the stock to a newly formed corporation, in exchange for which the new corporation issued all of its stock to the taxpayer. Then, the taxpayer caused the new corporation to liquidate and distribute the stock to her. Though the transaction literally satisfied the reorganization provisions of the Code, the Court held that the transaction was a "mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to organize the business or any part of the business, but to transfer a parcel of corporate shares ..." *Gregory*, 293 U.S. at 469. *See also West Coast Marketing Corp. v. Commissioner, supra* at 40-41, ("The record persuasively indicates that Manatee was incorporated for the purpose of being used as a conduit for passing title... It engaged in no business and served no purpose other than to hold title pending the contemplated transfer.").

On our facts, since it appears that the sale of the [redacted] [redacted] stock from the family member shareholders to [redacted] was prearranged [redacted] appears to have played the role of conduit. As in *McWilliams v. Commissioner,* noted above, the conduit should be ignored for tax purposes. For income tax purposes, then, the family member shareholders are deemed to have sold their shares directly to [redacted]. Recommended factual development is outlined in the attached memorandum.

I.

B. 3. <u>Step-Transaction</u>

Another similar argument is the step-transaction doctrine. This doctrine combines a series of individually meaningless steps into a single transaction. *See McDonald's Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982); *Esmark, Inc. v. Commissioner,* 90 T.C. 171 (1988), *aff'd in an unpublished opinion*, (7th Cir. Sept. 15, 1989); *Penrod v. Commissioner,* 88 T.C. 1415 (1987).

In *Esmark, supra*, Mobil purchased Esmark stock from the public as part of a prearranged plan to permit Esmark to sell its energy subsidiary without gain recognition under sections 311(a) and 311(d)(2)(B), as then in effect. Esmark then redeemed those shares from Mobil in exchange for the appreciated stock of Esmark's subsidiary. The Service applied the step-transaction doctrine to recharacterize the transaction as Esmark's sale of its energy subsidiary to Mobil for cash, followed by Esmark's redemption of its shares from the public with the cash proceeds from the sale. In denying the Service's application of the step-transaction doctrine to these facts, the court stated, "This recharacterization does not simply combine steps; it invents new ones." *Esmark*, 90 T.C. at 196. In essence, the court was stating the principal that a taxpayer is free to choose the form of a transaction, where more than one form is legally permissible. The step-transaction applies, on the other hand, where a taxpayer interposes meaningless steps to reach a result that the taxpayer could have reached directly.

In this case, the family member shareholders could have sold their shares directly to [redacted] to achieve the same result. The interposition of the sale to [redacted] and from [redacted] to [redacted] appears to have been devoid of any business purpose. On these facts, the step-transaction doctrine should be available to combine the series of meaningless steps into a single transaction: the sale of the family member shares directly to [redacted]. Again, the revenue agents should locate documents exhibiting [redacted]'s intention to purchase the stock from the family member shareholders.

I.

B. 4. <u>Completion of First Theory-Explanation</u>

To summarize, we have shown that the [redacted] percent block of shares exchanged for [redacted] stock was not purchased within the meaning of section 338. In addition, we have raised several arguments for treating the sale of the family member shares to [redacted] and from [redacted] to [redacted] as a sale from the family member shareholders directly to [redacted]. The final step in the first theory is to affirmatively show that at least [redacted] of the family member shares sold to [redacted] through [redacted] are attributable to [redacted] or to another incorporator of [redacted] who is related to [redacted] under section 318(a).

Under the attribution rules of section 318(a)(1)(A), [redacted] constructively owns stock held by his wife, children, grandchildren and parents.[7] Making these determinations is primarily a factual endeavor. Thus, the revenue agents must carefully determine the family relationships of the family member shareholders. In addition, it is crucial that the ownership of these shares be traced back for at least two years prior to the transaction. This is necessary to ensure that the record owners of the family member shares at the time of the transaction were not transitory or otherwise calculated to avoid the attribution rules.

I.

C. The Second Theory-Explanation

The second theory is also based on the argument that the sales to [redacted] and from [redacted] to [redacted] should be ignored for income tax purposes. That argument is followed by the contention that all the family

[7] For purposes of attribution we consider only [redacted], who owned more than 50 percent of [redacted], because under section 318(a)(3)(C), [redacted] is considered to own all stock owned directly or indirectly by any stockholder owning 50 percent or more in value of the corporation. Thus, to the extent that ownership of [redacted] stock can be attributed to [redacted] under these rules, those shares would not be considered "purchased" for purposes of section 338. Section 338(h)(3)(A)(iii). If [redacted] is related to another incorporator who is related to seller, section 338(h)(3)(A)(iii) also applies.

member shares transferred to [redacted] were part of a transaction to which section 351 applies.[8]

Section 351(a) applies to transactions where property is transferred to a corporation by one or more persons solely in exchange for stock in the transferee corporation and, immediately after the transfer, the transferors are in control of the transferee corporation. If property or money is received in addition to the stock of the transferee corporation, gain is recognized but not in excess of the money and the fair market value of property received. Section 351(b). If section 351 applies to the transfer of more than 20 percent of the [redacted] stock, no section 338 election is available to [redacted] because it will not have acquired by purchase the requisite 80 percent.[9] This conclusion follows from the fact that, if section 351 applies, [redacted]'s basis in the [redacted] stock is determined by reference to the basis of that stock in the hands of the transferors. Sections 362(a)(1) and 338(h)(3)(A)(i). This conclusion also follows from the section 338(h)(3)(A)(ii) exclusion of transactions to which section 351 applies from the definition of purchase.

According to this theory, the family member shareholders transferred their stock to [redacted] in exchange for [redacted] stock. After the transfers, the family member shareholders controlled [redacted] because they possessed more than 80 percent of the only class of [redacted] stock outstanding.

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[8] The need for factual development is especially acute here, where only those family member shareholders who received either only stock or stock and cash, can be considered as transferors in a section 351 transaction. The family member shareholders who received only cash for their [redacted] shares, cannot be considered as transferors for section 351 purposes.

[9] We are now considering whether stock acquired in a section 351 transaction with boot, the basis of which is determined under section 362(a) but which is equal to the stock's fair market value, is purchased within the meaning of section 338(h)(3)(A)(i).

See section 368(c). Those family member shareholders who received cash in addition to [redacted] stock may be considered to have received "boot" in the transaction. Section 351(b). Accordingly, they will recognize gain to the extent of the cash they received. Section 351(b)(1)(A).

To support this theory, the revenue agents must determine exactly how much stock each family member shareholder owned before the transaction and exactly what each such member received in exchange for their [redacted] shares. We are in the process of researching whether a court would respect the separate step of the sale of [redacted] stock for cash or view these cash purchases as part of the section 351 transaction. Recommended factual development is outlined in the attached memorandum. Particularly, we must be able to demonstrate that more than 20 percent of the family member shares were transferred by shareholders who received either just stock or stock and cash in exchange for their shares. If we can show that more than 20 percent of the [redacted] shares were part of a section 351 transaction, then the taxpayer will have failed to acquire by purchase the 80 percent required to make a section 338 election.

I.

D. <u>The Third Theory</u>

As noted above, we have not determined whether we can advance the third theory in connection with this case. As described above, this theory entails recharacterizing the transaction as a redemption by [redacted] of the shares acquired for cash, followed by an exchange of the [redacted] stock for the stock of [redacted]. That is, under this theory, this stock-for-stock exchange would constitute the only [redacted] stock treated as being acquired by [redacted]. The stock exchange would qualify as a "B" reorganization or a section 351 transaction. Thus, those shares would not be purchased for purposes of section 338 and no step-up would be allowed. Section 338(h)(3)(A)(i) and (ii).

While we have not committed to advancing this theory, we believe it is important for the agents to pursue the factual determinations necessary to support this theory (i.e., that the loans made in form to [redacted] were, in substance, loans to [redacted]). Recommended factual development contained in attached memo.

II. Litigation Hazards

Clearly, there are litigation hazards facing the Service in this case. It is difficult to evaluate those hazards due to the preliminary nature of the factual development. Nonetheless, we believe that this matter presents very significant issues and that the Service should further develop the facts.

The first theory, if the facts show that the requisite number of shares were constructively owned by [redacted], will be based primarily on ignoring the [redacted] purchases/sales for income tax purposes. While the Service has not always been successful in its attempts to look through steps of a transaction, this case appears extremely abusive. Accordingly, we believe that a court is likely to be receptive to the government's arguments. In addition, the first theory does not require a recharacterization of the transaction, but looks to what actually transpired in substance. This is in the government's favor.

The second theory, in which the cash purchases of [redacted] stock is treated as part of the section 351 transaction, arguably reflects the substance of the transaction. The taxpayer, however, may argue that the transfer of some [redacted] shares for cash was a separate and distinct part of a transaction from the exchange of [redacted] shares for [redacted] stock.

Although the taxpayer has indicated that it intends to raise *Esmark* as a defense to the Service's characterization of this transaction, we do not believe that *Esmark* poses a significant litigation hazard in connection with the first two theories. In *Esmark*, the petitioner cast its transaction in one of several permissible forms. Since several viable forms were available, the Tax Court held that the petitioner was free to pick any of those forms. On our facts, however, the taxpayer did not choose one of several permissible forms. Instead, the taxpayer interposed a meaningless step into a direct sale. Thus, *Esmark* should not apply to prevent the Service's treating the instant transaction in accordance with its substance. On the other hand, *Esmark* does pose a litigation hazard with respect to the third theory.

The premise for the third theory is that the $[redacted] used to purchase the [redacted] stock was borrowed by [redacted] and not by [redacted]; [redacted] merely served as a conduit or agent for those funds. [redacted] then used those funds to redeem the shares which were purportedly sold to [redacted]. For this theory to succeed, we require substantial and unequivocal documentary evidence. *Esmark*, the taxpayer can claim, stands for the proposition that a taxpayer can structure a transaction in any legal manner. Since it was just as legally viable for [redacted] to borrow the funds as it was for [redacted] to borrow the funds, the Service should be precluded from recharacterizing the loan to [redacted] as a loan to [redacted]. This argument has merit. In addition, the third theory recharacterizes the form of the transaction from a sale/exchange to a redemption/exchange. Based on the facts as they have been developed so far, we believe that a court is unlikely to be receptive to such an argument, particularly in light of *Esmark*, in which the Tax Court refused to accept the Service's recharacterization of a redemption as a sale. Nonetheless, we believe it is a possible characterization of this transaction and await further factual development.

As an overall evaluation, we believe this case presents issues well worth pursuing and that you should proceed with factual development of the issues.

III. Concerning Your Analysis

The analysis of this transaction in your memorandum was obviously thoroughly researched and well thought-out. Accordingly, we wish to explain our reasoning for not adopting all of the arguments you considered.

III.

A. The Esmark Analysis

Your analysis of the *Esmark* case and its application to the facts of the instant matter is basically an articulation of the conduit theory discussed above in Section I.B.2. The *Esmark* case, as you point out, represents a fact pattern in which the court found that the intermediary was not acting as a conduit, but rather was playing a substantive role. You then distinguish that transaction from the [redacted] transaction.

We agree with your analysis of *Esmark* and we adopt the conduit theory enunciated in your discussion. In addition, as it applies to [redacted], we adopt two theories similar to the conduit theory, namely, the transitory ownership and step-transaction doctrines. If we determine that the Service can advance the third theory discussed above, we will also apply the conduit theory to [redacted] in its role as intermediary between the lending banks and [redacted].

As you point out, we will not be able to fully appraise the litigation hazards, in general, and as presented by *Esmark, specifically,* until the facts of this matter are fully developed.

III.

B. The Section 338 Policy Considerations

While we agree with your assessment of the policy considerations behind section 338, we do not adopt this as a separate argument to disallow taxpayer's section 338 election. Significantly, subchapter C is a series of technical provisions and, where technical compliance has been observed by a taxpayer, the Service prefers to rely on arguments concerning the substance of the transaction itself, rather than attacking the transaction based on congressional intent that diverges from the statutory provision implementing such intent.

In this type of situation, we contend that the substance of the taxpayer's transaction did not comply with the technical requirements of section 338. We believe that a policy argument is best adapted in this situation to encourage the court to look through the [redacted] purchases/sales as a meaningless step.

III.

C. Interplay Between Sections 338 and 304

This is a *very* clever argument and, as an historical aside, was discussed in the National Office several years ago.

Specifically, if all the [redacted] shareholders are considered as in control of [redacted] prior to the transaction and they all transfer their [redacted] shares to [redacted], section 304(a)(1) may arguably apply to preclude a qualified stock purchase of [redacted] stock by [redacted]. Section 304(c)(2)(B). Unfortunately, Treas. Reg. § 1.338-4T(c)(5) disallows the application of 304(c)(2)(B) to the family member shareholders who sold out entirely. *See* Treas. Reg. § 1.338-4T(c)(4) regarding the combination of redemptions and stock purchases (this is distinguishable from [redacted]).

The other argument supporting the application of section 304, that is, the control premium argument, also presents a difficulty. As you point out, to apply section 304 to this transaction, we would have to show that the family member shareholders who controlled [redacted] after the transaction, controlled more than 50 percent in value of [redacted] *before* the transaction. Historically, the Service has not been successful in ascribing a high premium value to control factors in this area. Furthermore, the facts do not indicate what percentage of the family member shareholders eventually became shareholders of [redacted]. As a result, the Service may be faced with attempting to argue that holders of as little as 20 percent of the [redacted] stock controlled more than 50 percent of its value. It is highly unlikely that the Service could prevail on such an argument.

III.

D. Reorganizations

Because section 368(a)(1)(D) specifically requires a transfer of assets, the Service cannot argue that this transfer of stock constituted a "D" reorganization given that [redacted] and [redacted] have both stayed in existence. This is a particularly crucial distinction in section 368(a), which draws bright lines between stock transfers and asset transfers.

Our primary concern with advancing an argument that the [redacted] transaction constituted an "E" or "F" reorganization is that such an argument is a doubled-edged sword. Specifically, if we prevailed on that argument, the flood-gates would be opened for taxpayers to characterize what would otherwise be taxable transactions, as nontaxable "E" or "F" reorganizations.

While we do not believe that this transaction could be construed as a recapitalization, based on current case law, it could be argued that the instant transaction constituted an "F" reorganization. *See Aetna Casualty and Surety Company v. United States*, 568 F.2d 811 (2d Cir. 1977); *Reef Corporation v. Commissioner*, 368 F.2d 125 (5th Cir. 1966).

In *Reef Corporation, supra*, the corporation redeemed 48 percent of its stock and then transferred approximately 80 percent of its assets to a new corporation. The new corporation, which was controlled by the same group that controlled the old corporation, received a step up in the basis of its assets on account of its purported sale of its assets to the new corporation. The Service prevailed in its characterization of the transaction as an "F" reorganization and, thereby, precluded taxpayer from taking a basis step up in its assets.

At that time, Service position was to bring as many transactions within the reorganization provisions as possible, to preclude basis step ups and, therefore, greater depreciation deductions (i.e., the liquidation/reincorporation problem). Since that time, the Service has decided that extending the reach of the reorganization provisions is not in the Service's best interest. In addition, current section 368(a)(1)(F) precludes the characterization of this transaction as an "F" reorganization. Furthermore, the legislative history indicates that this is not the type of transaction contemplated under this provision. Moreover, the use of a holding company to execute an "F" reorganization is problematic. Accordingly, we do not believe that we should advance that argument in this case. If we did, we would be extending "F" reorganization treatment in a situation where less than 40 percent of the original shareholders retained an interest in the corporation.

In your discussion, you cite Rev. Rul. 61-156, 1961-2

C.B. 62, in which the Service held that a shift in proprietary interest was functionally unrelated to a simultaneous reincorporation. This ruling does not apply in this case since the shift in proprietary interest in the [redacted] transaction was functionally related to the ultimate purpose of the transaction.

We agree that the continued viability of the pre-TEFRA line of cases to current law poses an interesting question. As discussed above, however, we do not believe that it is in the Service's best interests to assert that the [redacted] transaction constituted an "F" reorganization.

We recognize that an argument can be made that the transaction constituted a redemption by [redacted] based on Rev. Rul. 78-250, 1978-1 C.B. 83. This argument ignores the existence of [redacted] for tax purposes. In Rev. Rul. 78-250, however, the holding company did not continue to exist after the minority shareholders were bought out. On our facts, however, [redacted] continued in existence as a viable corporation. This distinction is crucial. This argument is not tenable in light of the more favorable arguments we have in this case, which require less recasting of the facts.

IV. Conclusion and Recommendation

As noted above, we believe that you should pursue factual development of the issues discussed in this memorandum. Accordingly, we wish to continue to work with your office to develop this case as more facts are ascertained.

We point out that, based on our preliminary analysis of this case, [redacted] may have received service income which they reported as capital gain from the sale of the [redacted] shares. You may wish to consider alerting the Service personnel responsible for auditing [redacted]

[redacted] of this potential issue.

If you have any questions, please contact Jerry Schwartzman at FTS 566-3335.

This memorandum is for COUNSEL USE ONLY.

DANIEL J. WILES

By: Alfred C. Bishop

ALFRED C. BISHOP, JR.
Chief, Corporate Branch
Field Service Division

Attachment:
List of Questions

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